Innovations in Rural and Agriculture Finance

Community-Based Financial Organizations: Access to Finance for the Poorest

Anne Ritchie

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Community-based financial organizations (CBFOs) are user-owned and -operated groups that provide mainly saving and lending services but may also offer other financial services such as insurance. These independent organizations are based in local communities, with local governance and management. CBFOs range in size. They can take the form of informal and unregistered groups of five to seven people, usually women, who meet weekly to save small amounts of money that they then lend to each other and possibly to other members of the community. They also include larger, slightly more formal groups of up to 40 people who have written by-laws, and they include small financial cooperatives. CBFOs flourish among people who have poor access to banks and nonbank financial institutions such as microfinance institutions (MFIs).

Market niche

The market niche served by CBFOs is the unbanked poor. In many countries, locally organized CBFOs, such as rotating savings and credit associations (ROSCAs), have served as financial intermediaries for their communities for generations. ROSCA members save a predetermined amount of money regularly. In each period, one member of the ROSCA receives the funds collected. ROSCAs thus allow people to accumulate, through small regular savings, a large lump sum that is available for investments, such as creation or expansion of small businesses, children's education, and home improvement. The main drawback of ROSCAs is that the money may not be available when needed because only one member collects the funds at one time.

Although MFIs formed over the past four decades have done a great deal to make financial services available to the unbanked poor, they have not, for the most part, been able to reach the poorest people, especially those who live in remote rural areas. The poorest are able to save and borrow only very small amounts of money, making it too costly for banks and MFIs to serve them. In remote rural areas with widely dispersed populations, banks and MFIs often cannot cover the costs of an extension agent or a branch office, even if they use modern technologies to reduce costs or group people together to achieve economies of scale. Thus, MFIs have been successful in broadening the number of people served but less successful in reaching the poorest.

Successful models

Experience has shown that successful CBFO models must incorporate a number of basic principles: social cohesion of group members, a focus on building up savings to fund loans rather than relying primarily on external sources of funds, and an organizational structure that enables governance and management by people who are often poorly educated and have little or no experience with financial management beyond managing their own households and economic activities. Two models in particular appear to work well on a large scale and have good prospects for long-term sustainability.

One model is the village savings and loan association (VSLA) model. Started in Niger by CARE International in 1991, the VSLA adopted lessons from the efforts of poor local women to save in this large, poor, sparsely populated country. Since then, CARE and other nonprofit development agencies have spread the model to 39 countries, the vast majority in Africa. VSLA groups, consisting of between 10 and 30 members, have simple rules that govern their savings and lending activities. Each member saves on a regular basis, and this money is then lent out at an interest rate and on loan terms decided by the group. Loans may be made to both members and nonmembers. Indeed, many members save but do not borrow and earn a good return on their investment through the interest charged to borrowers. At the end of a given period, usually a year, the savings and the interest the VSLA earned are distributed to the members, and a new cycle begins. The distribution feature of this model keeps the amounts of money that the members must manage at a level commensurate with their financial literacy. It also enables all members to receive a lump sum on the same date, often one that coincides with most members' need for funds, such as an annual festival, the start of the planting season, or the date that school fees must be paid. VSLAs do not generally link with banks or MFIs because experience has shown that members' savings are generally sufficient to meet their credit needs, and injection of external loan funds has caused many groups to fail.

The self-help group (SHG) model, begun in India several decades ago, has become the dominant microfinance model in that country, especially for the rural poor. SHGs usually have between 10 and 20 members who save regularly and lend the money out to members only. The funds saved are not distributed back to members, but, rather, grow over time. SHGs in India often receive small amounts of seed capital from government or donors. They usually have an explicit goal of bank linkage, which has been facilitated by the high density of banks in rural areas and by a government policy stipulating that banks' portfolios must include rural loans. Many SHGs belong to federations that provide them with access to external capital, technical assistance in areas such as accounting, and greater bargaining power with government and banks. As of 2007, India had approximately 69,000 SHG federations.

The principal differences between the models are the following:

- VSLAs are self-contained at the village level, whereas SHGs link with banks and form federations with other villages.
- VSLAs distribute all savings and earnings back to members at the end of the year, whereas SHGs add new savings to existing savings with no automatic distribution mechanism. This difference makes VSLAs easier for nonliterate people to manage but allows SHGs to accumulate more capital for lending.

Matching CBFO models with communities' needs

The design of a CBFO program should be responsive to prevailing local conditions. A number of factors should be taken into consideration, including the demand for financial services and the proximity of banks and MFIs. In poor rural areas with weak local economies dominated by subsistence farming and few new business opportunities, VSLAs can provide an effective way for households to manage their financial resources. Savers are able to earn a return on their investment by making their capital available to those with viable businesses. If banks and MFIs are distant, as in the rural areas of many African countries, attempting to foster bank linkage may be more expensive than is warranted by the limited demand for loans.

In areas with more vibrant economies and greater population density, the bank linkage and federation aspects of the SHG model enable groups to draw on external funds for the growth of members' businesses. Federations can help SHGs with financial management and may also offer training aimed at strengthening the SHGs. However, because both the bank linkage and federation aspects of the SHG model add significant levels of complexity, external support from a technical-assistance provider may be required for a long period of time.

Both VSLAs and SHGs are initially formed and nurtured by trained extension agents. Experience with both models has shown that once the model has been established in a particular area, setting up new groups can be less expensive because members of existing groups can spread the model to other communities through informal linkages between communities or through the formation of associations of trainers who are themselves group members.

Leveraging finance and partnerships with mainstream financial institutions

The question of external financing has generated great debate. Many CBFOs have failed following the infusion of donor or government funds into fragile young organizations lacking the skills to manage this money. External credit may also draw into the membership people whose main objective is to obtain a slice of donor largesse rather than to contribute to the slow but steady buildup of the group through its own efforts. Yet it is precisely these efforts that are needed to build effective governance and management.

Nevertheless, partnerships between CBFOs and mainstream financial institutions can be beneficial, especially if implemented incrementally. In the simplest form of partnership, CBFOs may bank their excess savings and earn interest on these savings. As the relationship develops, the bank or MFI is able to assess the capacity of the CBFO to manage its own funds. In a World Bank–supported project in Sri Lanka, rural banks have been eager to develop relationships with CBFOs, which provide banks with easy access to a large number of rural customers. In some cases, the banks have sent their representatives to the villages to open the bank accounts. Such confidence-building measures can, over time, lead to a willingness on the part of the bank or MFI to extend credit to either the CBFO (for on-lending to its members) or to individual members who have viable business plans.

The way forward

The ability of CBFOs to govern themselves effectively and to manage their operations so that savings are secure and loans are repaid is paramount for their long-term sustainability. Donors and government can add value by funding programs that train local people to develop viable groups and by providing technical assistance for the development of simple governance, operational, and accounting systems that can be implemented locally.

Donors and governments should also fund program evaluations, using performance criteria that allow comparison across programs and models. The single most important performance indicator is repayment performance—that is, the ability of CBFOs to get borrowers to repay their loans in a timely way. Nonrepayment of loans is the greatest threat to the financial sustainability of any financial organization, including CBFOs. This threat is increased by the tendency of donors and governments to provide CBFOs with large loan funds that are beyond their capacity to manage effectively. Significant amounts of external funding—beyond small seed funds that help groups get started—should be linked to their performance in managing the group's own funds. This careful approach will enable CBFOs to develop a strong foundation that enhances their prospects for long-term sustainability. ■

For further reading: J. Murray and R. Rosenberg, Community-Managed Loan Funds: Which Ones Work? Focus Note No. 36 (Washington, DC: Consultative Group to Assist the Poor, 2006), www.cgap.org/p/site/c/template.rc/1.9.2577/; A. Ritchie, Community-Based Financial Organizations: A Solution to Access in Remote Rural Areas? Agriculture and Rural Development Discussion Paper 34 (Washington, DC: World Bank, 2007); APMAS, www.apmas.org/; Gemi Diriya Foundation, www.gamaneguma.lk/sub_link_view.php?doc=19; VSL Associates, www.vsla.net/.

***Anne Ritchie** (AnneFRitchie@aol.com) is a World Bank microfinance consultant.*

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